

EDELWEISS ET-Now Lead Indicator Index (EELII)

Be future ready

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**WHEN YOU KNOW WHERE THE ECONOMY IS HEADING,
YOU KNOW WHAT TO DO.**



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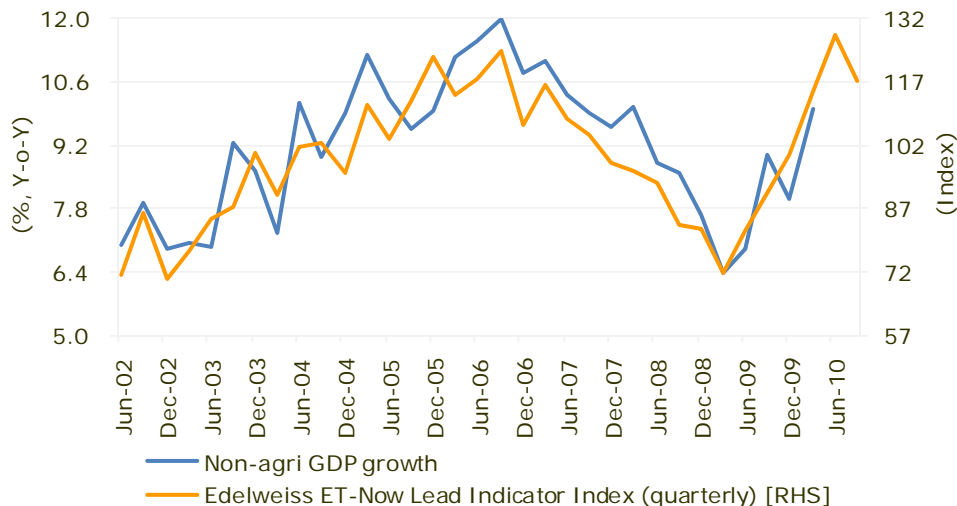
Edelweiss Securities Limited

■ **EELII moderates to 117 for Q2FY11...**

The Edelweiss ET-Now Lead Indicator Index (EELII) has moderated to ~117 for Q2FY11, a tad lower than ~128 in Q1FY11.

EELII, a composite weighted average index of a number of macro-variables exhibiting strong predictive ability of the core trends in the Indian economy, has moderated for the first time since March 2009. Earlier, EELII had been effective in capturing the upturn in the economic cycle during the past few quarters. From a trough of ~73 in Q4FY09, the indicator touched ~128 by Q1FY11 — the fastest in the current decade.

Chart 1: EELII moderates a tad



Source: CSO, Edelweiss research

Each of the lead variables constituting the index affects the real economy with different lead periods. For example, as per our model, the effect of change in policy interest rates (repo rate) is most pronounced on the economy with a lead of ~9-12 months, while the impact of change in commercial vehicle production is the highest with a lead of around three months. EELII has historically predicted non-agriculture GDP growth closely; the adjusted coefficient of determination (adjusted R-squared) for the multiple regression is ~0.80.

Uptick in EELII over the past five quarters was contributed by a host of factors—strong production of commercial vehicles, surge in non-oil imports, buoyant resource mobilisation in the domestic primary market and a reasonable interest rate scenario. However, of late, certain variables like cement dispatches and government expenditure, among others, are turning softer. Pressure on interest rates is also set to reflect on EELII gradually.

■ **... likely to stay soft in H2CY10; capex trajectory holds the key**

EELII had correctly projected a growth of 10% Y-o-Y in non-agri GDP during Q4FY10. For Q1FY11 also, EELII predicts well over 10% Y-o-Y growth. However, for Q2FY11, we could see a moderation in non-agri GDP growth to a notch below 10%. We, thus, expect a moderation in non-agri GDP growth in Q2FY11 for the first time in five quarters. By and large, we expect a softer set of numbers for non-agri GDP for the rest of CY10.

Certain real economic indicators are also suggesting moderation. Industrial growth is showing signs of consolidation (IIP down to ~7% from high double-digit growth a couple of months back), headline inflation has softened below 10% and Y-o-Y growth

for exports has also remained modest. While these are distinct signs of moderation after the sharp surge in Q1FY10-Q1FY11, they should, in no way, be interpreted as signs of slowdown. Rather, this is a phase of consolidation towards a more sustainable growth path and if anything, confirms our view that overheating concerns should start abating.

As we move towards a more sustainable growth path, capex trends will have a major role to play in determining the growth trajectory. So far, trends suggest that capex plans of India Inc. are broadly on track; however, a lot will depend on how these plans are implemented over the near-to-medium term.

- **RBI stance to be less hawkish**

RBI was demonstratively hawkish in its July policy review, where it shifted its monetary stance 'decisively' to contain inflation and inflation expectations. While we acknowledge the need for gradual normalisation of interest rates, we do feel that further aggressive monetary actions could be detrimental to the broadening of economic recovery and business sentiments. Several economic indicators over the past one month have only strengthened our belief that overheating concerns in India are overdone. Against this backdrop, we maintain that RBI may hike policy interest rates (repo and reverse repo) by another 25-50bps by October, followed by a relatively softer monetary stance through rest of FY11.

- **Uncertainty over global growth remains; India largely impervious**

In recent months, uncertainty regarding global growth has heightened once more. US incoming economic data (retail sales, housing market, consumer confidence, manufacturing, inflation, etc.) have deteriorated much beyond consensus expectations. Growth environment in Europe is clouded with uncertainty, while economic indicators in China are turning softer. Indicators for global growth, for e.g., the JP Morgan Global PMI have been softening over the past three months. These global trends considerably influence domestic business sentiments, capital inflows and trade in goods and services, thereby influencing aggregate demand in the domestic economy. However, given the relatively lower dependence on exports, India remains more insulated to global slowdown than most peers.

Annexure

■ Basic concepts and construction of EELII

The EELII, which is released on a monthly basis effective October 2009, is available with a lead period of around three months before the availability of actual data on GDP for any particular period.

This is a composite weighted average index of a number of macro-variables that typically exhibit a strong predictive ability of the core trends in the Indian economy. Instead of tracking different macro-variables, which typically influence the economy with different intensity and varying lead times and often—especially at times of turns in the economy—move in opposite directions, this single indicator is typically capable of summarising movements in all such different variables into one value. Hence, this can be an easy, yet effective, tool to track and predict inherent trends in the economy. The construction of the index was based on a multiple regression framework using quarterly data for the past 10 years.

As a starting point, around 60 different macro-variables—spanning over capital availability, credit demand, cost of funds, PMI, freight rates, property prices/rentals, consumption demand, intermediate goods production, electricity production, tourist arrivals and commodity prices—were considered.

This initial set of indicators was trimmed down on the basis of three criteria—degree of influence on non-agricultural GDP (high correlation), availability of high frequency and reliable data (longer/sufficient history), and lead property (lead period of at least one quarter). Redundancies were also removed for sets of indicators demonstrating auto-correlation (for example, supply of broad money (M3) and non-food credit offtake).

On the basis of such criteria, the final set of variables that was chosen for inclusion in the index are as follows: (1) credit offtake; (2) policy interest rates; (3) slope of the yield curve; (4) non-oil imports; (5) commercial vehicle production; (6) cement dispatches; (7) domestic steel prices; (8) government expenditure; and (9) resource mobilisation in the primary capital market. The range of variables included in the index augurs well with several lead indicator indices followed globally.

SI No.	Variables used as lead indicators by other studies	Whether used in EELII/ other comments
1	Broad money (M2)	Credit used as proxy - broad money and credit highly correlated
2	CPI	In India, CPI is largely determined by food prices and exposed to supply shocks in agriculture. Domestic steel price has been used instead as a proxy of inflation of industrial commodities
3	S&P500	Resources raised from domestic market used as proxy
4	Government borrowings	Government expenditure used as a proxy
5	Consumer sentiment / Advance monthly sales for retail and food services/ Real final sales of domestic product	No long dated series exists for India. Non-oil imports and commercial vehicles production used as indirect indicators of retail sales
6	No. of manufacturing orders for consumer goods and materials	No specific data series exists for India. Commercial vehicle production reflects demand for consumer goods. PMI could have been used; but the available data series too short for any statistically meaningful regression
7	Amount of new orders for non-defense capital goods	No specific data series exists for India. Domestic steel prices reflect input demand for capital goods to some extent
8	Initial applications on unemployment insurance	Not used in EELII due to data unavailability
9	Housing permits	No data series exists for India. Cement despatch figures / Domestic steel prices reflect construction activity to some extent
10	Slope of the yield curve	Used in EELII also

Lack of availability of data for certain potential lead variables like housing starts, property prices/rentals, PMI, business confidence indices, job losses etc., however, imposes constraints in their inclusion in the index. While the basic approach for constructing the indicator has by and large been in line with several other lead indicators followed internationally, certain customisations have also been made to suit Indian conditions.

Weights of different variables were assigned after eliminating time trends and seasonality, and after normalising all the variables to one common scale. Weights were determined on the basis of the regression model, hence, assigning more weight to indicators that have been historically shown to have a greater influence on the overall activity level and have captured turns in the economy better with a lead.

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